Financial Markets Functioning Well in a Pandemic

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Five reasons to be cautiously optimistic about their continued resiliency

NCAA officials did their part in addressing COVID-19 fears, but cancelling the 64-team tournament didn't extinguish March Madness. It is alive and well in financial markets. Each day delivers upsets and unexpected developments, leaving commentators struggling to keep up with their recycled vocabularies.

Superficial headlines abound. Markets reel. Stocks plunge. S&P gives back gains. Trillions wiped out. Investors riled. It is hard to find information of substance. Like being on the scene of a tragic accident, onlookers can't get beyond the surface images.

Perhaps the most intelligent thing I've read all week came, aptly, from the WSJ's Intelligent Investor columnist Jason Zweig. He reminded his audience of enduring good advice from Warren Buffet's mentor, Benjamin Graham. [1] Buy-and-hold investors shouldn't be spooked by down markets. Sharp price declines provide an opportunity to buy wisely. And if you are trying to time the market (a.k.a., a speculator), be forewarned that in games of chance, casinos are the winners. All of this trading is great for market-makers on Wall Street.

It is likely that the news driving markets could get worse as the "what-if" tree grows. The economic and social consequences of the recently announced travel ban and unprepared healthcare system is the current focus. I worry most about a potential leadership crisis. Imagine an election year where candidates face significant mortality risk. The coronavirus has shown to play favorites among the aged, which includes three presidential candidates and septuagenarian leaders of Congress. And some of them have revealed they may already be infected with hubris ... about the risks.

But prospects aren't entirely bad. Financial markets have actually handled the pandemic remarkably well. As we head into a new week of market uncertainty, there are several reason to be optimistic about their continued resiliency.

1. The market-wide circuit breaker worked for a second time

This could be the most encouraging news of last week. The market-wide circuit breakers were triggered twice, and both times with intended effects. As I wrote earlier in the week, the SEC has for years sought the right recipe for market-wide trading halts. Heretofore the triggers were either set too tight (October 1997 Asian flu) or too loose (May 2010 Flash Crash). The latest calibrations appear to be just right. The types of market stresses necessary to assess their effectives are few and far between. That two such episodes came in the same week provides excellent data for the market experts to evaluate.

At first blush there are three reasons to believe that current settings are just right. First, there was a free fall in prices with no apparent bottom. We don't get to see the counterfactual – no halt – but there was no slowing of the decline and it is easy to envision a larger drop absent the intervention.

Second, coming out of the pause, prices returned to bi-directional movements. The fluctuations were intense, but there were both buyers and sellers, and markets were facilitating price discovery in an orderly fashion. Third, and importantly, the second halt appears the instant replay of the first. That is, the experiment was repeated. It is hard to overstate the importance of this. Having confirmatory analysis of a rare event gives great comfort in interpreting results.

My interpretation of the halts are by no means the final word. And I could be wrong. SEC experts and economic staff will need to study the events in more detail, and report their findings.

Related analysis on single stock circuit breakers also merits reporting. First approved by the SEC under the "limit up limit down" plan in 2012, exchanges like the NYSE and NASDAQ privately report these extraordinary market volatility occurrences. [2] For example, there were 1,278 single security trading halts during the August 24, 2015 flash crash. Many stocks struggled to reopen, and exchanges subsequently enhanced their reopening auction process. [3] This would be a good time to report how those enhancements fared.

2. This is not a financial crises

In this the President is right. Unlike during 2008 and 2009, financial institutions and instruments are not the problem. We are not here because of dodgy loans, over-levered firms, inappropriate use of credit derivatives, or suspect structured financings.

This is important because the US government will depend heavily on the financial system to address the looming economic crisis. Companies will increasingly depend on their loan and credit facilities with banks. And as they draw down, the Fed is positioned to help banks meet those obligations by injecting liquidity into their balance sheets – giving banks cash in exchange for their safe assets through repurchase agreements. The New York Fed has already committed over a trillion dollars to this end. [4]

If banks begin to struggle, the Fed can do more. During the financial crisis they purchased 'troubled' assets. Back then, valuations were uncertain because of questionable financial structures. Today, uncertainties center on economic projections. While scary, I would argue that these are better uncertainties to deal with, because they are more transparent and likely to resolve more quickly. Similar relief is almost certainly already being considered, and likely buoyed by the fact that the government ultimately recouped the cost of its relief programs during the financial crises. [5]

It is important that the Fed does whatever it takes to keep banks stable. Even the perception of a liquidity issue can be the death knell for a financial institution. Just ask former leaders of Bear Sterns. The week before they failed, the SEC (then overseer of major investment banks) indicated that the firm was comfortably capitalized. [6] It didn't matter. The market thought otherwise, and a bank run ensued. Bear lost its funding. And as scholars have long explained, in a panic, even healthy banks can fail.

Of course, there are limits to what a bank can do, even as an agent for the government. Most notably, they cannot replace lost wages. This is a prospect faced by many Americans. And it is not just an economic issue. There can be a large social cost, both immediate and long term. Ability to pay rent and buy food is a real concern. Individuals and families unable to bridge the financial disruption are vulnerable to losing the most basic human needs – safety, food, shelter, let alone access to healthcare in the face of a pandemic.

Ensuring at-risk individuals and families remain secure and productive members of society should be a priority. A direct stimulus to US households – send them a check they can cash – is the most immediate way to provide relief. We did this on a small scale during the financial crisis. It might be appropriate to revisit the idea on a larger scale. See what a Duke University professor says about that; he argues that the time to do it is now, before the irreversible consequences of inaction take hold. [7]

3. No reported failures of non-bank financial institutions

If banks remain healthy and a financial crisis is averted, it will be in large part due to the Dodd-Frank Act and Basel III reforms. Banks are subject to stricter capital and liquidity requirements and have pursued safer risk profiles. And they spent the past decade cleaning up badly damaged balance sheets.

But this doesn't mean that risks have dissipated. Many financial activities simply shifted from the banking sector to less regulated pastures. For example, some of the risky loans in the US are now often underwritten and held by non-banks, sometimes referred to in the pejorative as 'shadow banks.'

Global Regulators have recently focused these types of borrowings, called leveraged loans on account that they are generally made to highly indebted (leveraged) borrowers. [8] There are worrisome signs that the loan origination standards have deteriorated, and that a stress event such as what we are witnessing now could generate widespread losses for their biggest purchasers, CLOs (Collateralized Loan Obligations), which securitize the loans and sell tranches rated AAA and down.

It might take some time to know whether these concerns have merit. And it is worthwhile to remember that similar concerns were leveled against CLOs at the onset of the financial crisis that ultimately proved unfounded. Nevertheless, weakened underwriting standards and less room to lower rates could make this time different. We won't know until the borrowers, companies whose debt generally rates below investment grade, meet or miss their scheduled interest payments. Learning the results could take some time to materialize.

Where these 'shadow banking' concerns are likely to appear first is in ETFs and open end mutual funds that hold corporate bonds. They hold a substantial amount of the high yield (non-investment grade) debt issued by risky corporate borrowers. A recent risk outlook by the SEC reports that bond funds have grow by more than $1 trillion since 2014. [9]

These funds are the canary in the coal mine. They offer daily or intra-daily liquidity on comparatively illiquid assets. This creates fragility. If the high yield corporate bond (and leveraged loan) market implodes, these funds could experience extreme outflows. Selling the less liquid bonds to pay exiting investors, if en masse, could push bond prices below their intrinsic values. Fire sale losses of this sort would be borne by remaining fund investors, giving all investors incentive to exit – a 'bank run' that engenders even more losses.

In the US, such an extreme scenario would likely result in a suspension of redemptions, an action requiring SEC approval. That we didn't see signs of this last week is a reason to be optimistic. It is possible that some funds are struggling, and may even be in talks with the SEC staff about their contingency plans. This would remain close-hold information to keep from spooking investors.

If funds continue to weather these extreme market conditions, credit may go to an Obama-era reform requiring enhanced liquidity risk management practices, and permitting the use of swing pricing to mitigate the dilutive effects of investors redemptions during stress periods. [10] Like with the market-wide circuit breakers, SEC economists will now have the type of data needed to perform a retrospective analysis of their effectiveness.

4. The Financial Stability Board has practiced for this moment

Just a few weeks ago, the Chair of the Financial Stability Board (FSB) sent a letter to G20 Finance Ministers and Central Bank Governors about the challenges facing the global financial system. [11] There was no mention of a pandemic, even though the World Health Organization and US government had already declared the coronavirus a public health emergency, and the press was calling it a global panic.

This might make the FSB seem slow off the blocks for an organization tasked with global financial stability. But to be fair, no one yet knew the true scope of the problem, and G20 communications of this nature are typically rather staid and go through so many rounds of review that changing the location of a preposition might have taken weeks for approval.

Moreover, the FSB has previously considered and written about the potential financial stability implications of a pandemic. In 2006, after the SARS episode, they published a note with some rather prescient insights about current development. [12] Here is one excerpt:

"In previous episodes, quarantines and travel restrictions have tended to have little effect, because the infection can spread well in advance of the appearance of observable symptoms. However, localised travel restrictions may help limit the spread of the virus in the early stage of a pandemic, while temporary banning of some public gatherings and closure of schools have often helped to reduce the speed at which disease spreads. A wide range of strategies will probably be employed, especially given the likely pressure on public authorities to demonstrate a strong response to the disease threat."

The same FSB note also highlighted the need for national authorities to (1) receive information from market participants on the extent of disruption; (2) act as a point of liaison between financial markets and the wider government emergency response; (3) provide information to the

the public on the functioning of markets and systems; and (4) explain the measures that authorities and markets are taking.

The current role of the FSB is to ensure these activities also occur across borders. When the Heads of State of G20 governments approved the FSB Charter in 2009 in response to the financial crisis, among other things, they envisioned the FSB would "promote coordination and information exchange among authorities responsible for financial stability."

Some would argue that this is the most important role of the FSB. For sure, it is also important to promote financial stability by developing strong regulatory supervision and financial sector-policies, which is the general focus of activities. But having a forum that fosters long-term relationships between key officials in governments across the world is critical at a time like this. It is the payoff from sitting through an endless string of pro-forma meetings in Basel Switzerland (headquarters of the FSB Secretariat). Everyone now knows who to call in a time of crisis.

With respect to the current crisis, to the extent we had to have one, the timing is not bad. It is hard to think of a time when the global financial community was more prepared. Most of the post financial crises reforms have been implemented and there are many new protections against systemic risk. And it comes at a time when some leaders, keen to loosen the reins on financial supervision, need reminding of why the global community went through a decade long exercise on improving financial sector resiliency.

The Chair of the FSB recently passed from Mark Carney, the former Governor of the Bank of England, to Randal ("Randy") Quarles, the Vice Chair for supervision for the Federal Reserve Board of Governors. This rotation in leadership might be important if not fortuitous in timing. Having a key US official at the helm increases US responsibility for global cooperation, an area that generally needs some improvement. This will be essential in coordinating an effective response to emerging economic and financial risks.

One aspect of Chair Quarles' letter to G20 Finance Ministers that he couldn't have known how right it was at the time of writing, is that "we now have an opportunity to review how our post-crisis reforms have worked."

5. Regulators haven't done anything irrational (yet)

My last area of optimism centers on the regulatory response to date. The Fed has stepped in with important if not largely predictable measures. The SEC has offered measured relief to market participants in areas that make sense (e.g., allowing virtual shareholder meetings, a delay in the submission of certain filings, and fully electronic trading for options trading) in light of current restrictions on physical gatherings. [14]

But having experienced the last crisis from the inside, it is hard to believe that some crazy ideas aren't being floated around.

In a previous post, I highlighted that it only took a few minutes after the market-wide circuit breaker was triggered for the media to write about a potential ban on short selling. While history shows this would be a mistake, such a measure continues to have widespread appeal, particularly by executives at companies who prefer that their stock prices not decline.

There are also rumblings about a return of the up-tick rule, a great depression era measure intended to alleviate downward selling pressure by permitting short sales only after a "tick up" in prices.

A good analogy to the up-tick rule are those little road strips that warn you a stop sign is coming – the small ripples in the pavement designed to change your driving behavior to improve public safety. Now imagine if they were everywhere. On every street and at every interval. It would be an incredibly inefficient public safety measure, not to mention incredibly annoying.

This is the up tick rule. It slows short selling during the 0.1% when it might make sense, during stress periods, but also the 99.9% of the time that it doesn't, when markets are operating normally. Following an experiment by the SEC in 2004 that allowed stocks with and without the uptick rule to run side-by-side, the SEC concluded based on a number of studies that it impaired market quality and was no longer necessary. [15]

Brett Redfearn, the SEC's current director of the Division of Trading and Markets, reiterated the obsolescence of the uptick rule during a 2018 appearance on CNBC, and again in another CNBC appearance earlier this month. [16] He also reminded viewers that a price test was already in place for stocks experiencing large price declines – i.e., the 0.1% stress periods.

This is the right position, and a reason to be optimistic that the SEC will not reintroduce draconian measures. But there will be continued a temptation to shoot the messenger – blame well-functioning price discovery as the cause of price declines.

Final thoughts

These are uncertain times, but I have never had more confidence in the resiliency of our financial system. If you had asked a panel of experts whether financial institutions would across-the-board withstand a stress period characterized by two trading halts in a single week, many would have been hesitant to say yes.

Last week yielded no trading glitches or failures at exchanges, no fund failures, and no major issues at securities dealers, clearing agencies, pricing services, or at other key points of financial market infrastructure. To this end, it was a good week.

My thoughts are with the many millions of other individuals and families who are scared about the future. I don't mean for my optimism to belittle the economic crises and potential hardships that could be upon us. My hope is that financial markets and their supervisory agencies will, unlike during the last crisis, mitigate rather than exacerbate the problems.

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[1] Jason Zweig, "What Benjamin Graham Would Tell You to Do Now: Look in the Mirror," Wall Street Journal, March 10, 2020, found at https://www.wsj.com/articles/what-benjamin-graham-would-tell-you-to-do-now-look-in-the-mirror-11583797707

[2] The plan was first submitted by the exchanges to the SEC on April 5, 2011, and began operating on a pilot basis in 2013. The most recent and 18th plan submitted by the NYSE on behalf of NMS members made the pilot permanent in April of 2019. See, https://www.sec.gov/rules/sro/nms/2019/34-85623.pdf

[3] See SEC "research note: Equity Market Volatility on August 24, 2015" at https://www.sec.gov/marketstructure/research/equity_market_volatility.pdf; Barbara Novick et al, "US Equity Market Structure: Lessons From August 24," October 2015 at

https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-us-equity-market-structure-october-2015.pdf; and SRO filing to enhance reopening procedures https://www.sec.gov/rules/sro/nasdaq/2016/34-79158.pdf.

[4] Repurchase agreements of maturities up to 3 months allow banks to replace high quality securities (e.g., treasuries) with cash. https://www.newyorkfed.org/markets/opolicy/operating_policy_200312a

[5] The US Government made available up to $700 billion through the Troubled Asset Relief Program [TARP] and ultimately recouped an amount close to the $450 billion it obligated. See, https://www.treasury.gov/initiatives/financial-stability/reports/Pages/TARP-Tracker.aspx#All. While reasonable minds continue to debate how successful this program was, particularly in light of the moral hazard risks many believe it engendered, it certainly performed much better than the inferred valuations at the time many of the assets were purchased (during the heights of the crisis).

[6] Former SEC Chairman Chris Cox describes the financial condition of Bear Stearns leading up to they failure in a letter to the Basel Committee on March 20, 2008, found at: https://www.sec.gov/news/press/2008/2008-48.htm.

[7] https://www.linkedin.com/pulse/time-act-now-david-robinson/

[8] Financial Stability Board, "Vulnerabilities associated with leveraged loans and collateralized loan obligations," December, 2019, found at: https://www.fsb.org/wp-content/uploads/P191219.pdf. Two of the concerns are covenant light (cov-lite) provisions that weaken creditor protections, and the clumsy 'add-backs' to reported earnings that make their ability to cover loan interest appear rosier.

[9] See, research staff paper issued by the SEC's Division of Economic and Risk Analysis, "DERA Economic and Risk Outlook," November 2019, found at: https://www.sec.gov/files/DERA_Quarterly%20Economic%20and%20Financial%20Outlook%20Nov%202019.pdf

[10] In 2016, the SEC adopted enhanced liquidity risk management and swing pricing rules, described at: https://www.sec.gov/news/pressrelease/2016-215.html. In 2018, the SEC amended the liquidity risk management rule. Instead of funds to reporting publicly the aggregate the percentage of asset into four liquidity classification, funds will submit the information confidentially.

[11] See FSB Press Release, "FSB Chair’s letter to G20 Finance Ministers and Central Bank Governors: February 2020," February 19, 2020, found at https://www.fsb.org/2020/02/fsb-chairs-letter-to-g20-finance-ministers-and-central-bank-governors-february-2020/

[12] FSB Publication, "Macroeconomic and financial stability issues raised by a global influenza pandemic," April 25, 2006, found at https://www.fsb.org/wp-content/uploads/r_0604.pdf?page_moved=1

[13] "Charter of the Financial Stability Board," June 2012, found at https://www.fsb.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf

[14] see, https://www.sec.gov/news/press-release/2020-62; https://www.sec.gov/news/press-release/2020-63; https://www.sec.gov/rules/other/2020/34-88318.pdf; and

https://www.sec.gov/news/press-release/2020-64

[15] See a discussion of the evidence from a transcript of the "SEC Roundtable on the Regulation SHO Pilot," September 2006, found at https://www.sec.gov/about/economic/shopilottrans091506.pdf.

[16] "SEC Director: Uptick rule didn’t work," December 2018, found at: https://www.cnbc.com/video/2018/12/20/sec-director-uptick-rule-didnt-work.html; and "SEC official says markets ‘functioning well’ despite high trading volume, volatility," March 3, 2020, found at: https://www.cnbc.com/2020/03/03/sec-official-says-markets-functioning-well-despite-high-trading-volume-volatility.html.